Weekly Updates Issue # 622

1. Weekly Markets Changes

[July 14, 2017]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
15,174.81 +147.7 +0.98%	2,459.27 +34.09 +1.41%	21,637.47 +223.4 +1.04%	6,312.47 +159.4 +2.59%	$0.7905 +1.40c +1.80%	$1,228.00 +16.10 +1.33%	$46.68 +2.35 +5.30%

2. Why Canada's recovery is still tenuous: IMF

[July 14, 2017] The International Monetary Fund has given the Trudeau government a passing mark for its handling of the economy since coming to power, but warns that "more difficult challenges lie ahead."

In a release, and in an annual report released by the Washington-based organization on Thursday, the IMF credits the government "for successfully reinvigorating the Canadian economy […]." But it also notes that "the ongoing recovery [in Canada] is skewed toward consumption. At the same time, there are uncertainties around the economic outlook."

In its report, the IMF says, "To support the economy, the government introduced tax cuts for the middle class, expanded family benefits, and raised infrastructure spending." This spending, combined with the Bank of Canada's historically low interest rates, "has succeeded in revitalizing the economy after a tough year in 2015," the IMF says.

In its release, the IMF suggests the best path forward would be to ensure the fiscal policy remains "expansionary in 2017, while in 2018, as the output gap closes, no further increase in the deficit would be required." (Note that the Liberals said in their last federal budget that they expect to rack up $142 billion in new debt via bond issuance.)

On monetary policy, the IMF says, "[…] Monetary policy should stay accommodative and be gradually tightened as signs of durable growth and inflation pressures emerge." The IMF's review and report was completed prior to the Bank of Canada's July 12 rate increase to 0.75% — the first hike seen in seven years — but released afterward.

Cheng Hoon Lim, the IMF's mission chief for Canada, said the rate increase reflected the fact the economy has been doing well over the past few months, though he advised the Bank of Canada to take things slow.
"We welcome the good news on the economy and note that even with the rate hike, monetary policy remains appropriately accommodative," Lim said. But, "given the considerable uncertainty around the growth and inflation outlook, the Bank should continue to take a cautious approach in further adjusting the monetary policy stance."
At a news conference on Parliament Hill, Prime Minister Justin Trudeau touted his government's approach to the economy. "We're going to continue to deliver on the commitments and the promises we made in the last election and in the throne speech we presented 18 months ago," he said.
He added, "Now is not the time to change from the strong approach that's delivering for Canadians. Now is the time to continue on the hard work we're doing to help Canadian families."
Yet, Trudeau can't forget the challenges that lie ahead.
The IMF has raised alarm bells about the amount of uncertainty in Washington and how that could impact Canada's economy over the long term. Among the issues is whether the Trump administration would significantly cut corporate taxes, which would make Canada less attractive to investors, and the future of NAFTA.
The IMF also cited major concerns about Canada's housing market, warning any sudden decline in prices could send shockwaves across the country. "The main risk on the domestic side is a sharp correction in the housing market that impairs bank balance sheets, triggers negative feedback loops in the economy and increases contingent claims on the government," the report says.
Further, there were also worries about the impact of further oil price declines. And, despite signs the Canadian economy is starting to turn around, the IMF found two important engines of growth had not met expectations: private sector investment and non-energy exports.
Overall, the IMF suggests in its release, "Policy choices will therefore be crucial in shaping the outlook and reducing risks."

3. Inflation to 2% within a year? It adds up, say economists

[July 13, 2017] Persistently low inflation has been puzzling to central bankers as they now wrestle with whether to gradually tighten monetary policies.

The BoC joined the lifting camp on Wednesday when it raised its key lending rate by 25 basis points to 0.75%, and said inflation — which averaged 1.4% in Q2 — could climb “close” to its 2% target by the middle of 2018. Ambitious words, no?

Inflation has been dampened by the forces of globalization, particularly competition from China and the “Amazon-ization” of retail, which has put downward pressure on the price of goods.

These global factors have been a big reason for low goods prices, CIBC economists say in a market note on Thursday. Goods inflation has been more muted than services inflation for decades, the economists say, noting: “there’s nothing that unusual about Canadian goods inflation (excluding food and energy) to be trending at close to 0%.”

The BoC, in its monetary policy report this week, said the inflation slowdown appeared “to be mostly temporary,” referring to heightened food price competition, electricity rebates in Ontario and lower in automobile price inflation. Together, those factors reduced inflation by 0.7 percentage points between Q1 and Q2 2017, the BoC said.

TD economists add in a note that weak inflation is a key risk to the central bank’s outlook. “[W]hile the macroeconomic backdrop supported a tightening of monetary policy, the inflation outlook did not. Clearly the Bank of Canada is placing more weight on the growth side of things,” the TD economists say.

RBC economists say they expect the BoC to continue with another rate hike in October, then hit pause on their tightening cycle “until they have greater confidence that inflation is heading to their 2% target on a sustained basis.”

But the CIBC economists say 2% inflation is likely to happen sooner rather than later. Accounting for housing price gains, unit labour costs and higher oil prices, they point to spring 2018.

“By pushing the C$ stronger, the Bank of Canada’s rate hike may have delayed achieving its 2% inflation target. But not for long,” CIBC says. “For each of the issues we looked at, the impacts are in the range of a decimal place or two on the CPI. But when added together, they’re material enough to push CPI inflation above the 2% target by next spring.”

4. Royal LePage sees 9.5% national price gain this year

[July 13, 2017] The aggregate price of a home in Canada increased 13.8% in Q2 from a year earlier, reaching $609,144, Royal LePage says in the latest release of its national house price composite data.

The data, compiled from proprietary property information from 53 of the nation's largest real estate markets, showed continued expansion in the largest metropolitan markets.

Royal LePage forecasts national aggregate home price growth will slow somewhat this year, increasing by 9.5% in calendar 2017 to reach $617,773.

"The rate of national house price appreciation that we experienced in the second quarter continues to be above what we would consider a normal range, driven primarily by very strong year-over-year price growth across much of Ontario," Royal LePage CEO Phil Soper says in a statement.

Greater Vancouver's housing correction, which started in August 2016, reversed in Q2, Royal LePage says, with the city now poised for continued price gains. In Q2, Calgary also posted its strongest year-over-year home price growth since the oil

The Greater Toronto Area moderated, however, as "the combination of eroding affordability and government legislation has pushed many buyers to the sidelines — at least temporarily bringing balance to the country's largest market and slowing home price appreciation within the region," Royal LePage says.

Soper says GTA home value price appreciation of 20% to 30% annually has not been "sustainable or healthy," though much-needed balance is returning to the market. "[T]he GTA's recent drop in sales activity may well signal calmer waters ahead for the province," he says.

The Montreal city centre's housing market saw near double-digit growth in Q2 amid a regional economic revival and an unemployment rate that has fallen to the lowest level since Statistics Canada started tracking it in 1976, Royal LePage says.

It adds that the BoC's 25-basis-point rate hike on Wednesday will help normalize economic and housing market conditions.

Within the last two years, Canadians spent more on mortgage principal payments than mortgage interest payments for the first time since Statistics Canada began compiling the data in 1990, the report says.

The ratio of debt to disposable income remains high — though it dropped in Q1 to 166.9% — while Canadians' interest-only debt service ratio was at a record low 6.1%. Royal LePage also pointed to Canada Mortgage and Housing Corporation mortgage delinquency rates, which show the hottest markets of Toronto (12 basis points) and Vancouver (15 basis points) have readings of less than half of the national average (34 basis points).

"While many commentators have feared the effect of an interest rate hike, we believe that the market is better served by a healthy economy that requires a return to normal conditions," Soper says.

5. BoC sounds bullish as key rate hiked to 0.75%

[July 12, 2017] The BoC raised its Canadian growth forecast on Wednesday as it lifted its overnight rate target to 0.75% — the first hike in almost seven years.

In a release, the bank says it is confident in its outlook for “above-potential” growth and the absorption of excess capacity in the economy. Though inflation is soft, the BoC deems that a temporary situation, attributable to factors such as technological advances.

“If lower inflation reflects increased global potential and heightened competition, it suggests higher living standards rather than signalling economic weakness,” says the central bank in its monetary policy report.

And, because there’s a lag between monetary policy actions and future inflation, the BoC says its timing is appropriate. With the 25 basis point rate hike, the bank rate is correspondingly 1% and the deposit rate is 0.5%.

Investor reaction

Though the bank is warding off future inflation with the hike, Avery Shenfeld, managing director and chief economist at CIBC Capital Markets, says in an industry note that the hike aligns with government policies aimed at cooling mortgage activity that’s not needed to sustain job gains.

Allan Small, senior investment advisor at Allan Small Financial Group, says it’s time for investors to monitor rate-sensitive investments like REITs, and conservative dividend players like utilities and telecoms. Sectors like financials and technology do better in a rising-rate environment.

But things won’t necessarily change in the near-term, he says. Investors should stay in the market and diversify, as always, while hedging for interest rate risk, geography risk and currency risk.

Strong Canadian growth

For the Canadian economy, near-term growth is expected to remain solidly above potential, with the BoC projecting a 3.0% annualized growth rate for Q2 2017 — up from the 2.5% forecast in April’s monetary policy report. Growth is broadening across industries and regions and therefore becoming more sustainable, the BoC says.

Household spending will likely remain solid in the months ahead, supported by rising employment and wages, and exports are expected to make an increasing contribution to GDP growth. Business investment should also add to growth, a view supported by the most recent business outlook survey.

Over its projection horizon, the bank estimates real GDP growth to moderate from 2.8% in 2017 to 2% in 2018 and 1.6% in 2019. The economy is now projected to reach full potential around the end of 2017, earlier than the bank anticipated in its last monetary policy report, when it had forecasted the first half of 2018.

As excess capacity is absorbed, and as relative price movements in food, electricity and cars dissipate, the bank expects inflation to return to 2% in the middle of 2018.

Growth outlook and financial markets

The BoC says the recent increase in yields on long-term sovereign bonds is driven by stronger global growth and market expectations of less accommodative monetary policy in advanced economies, including the reduction of the Fed's balance sheet expected to begin later this year. Global credit spreads remain near post-crisis lows, and equity prices are close to past highs. Further, the U.S. dollar has seen a modest depreciation.

The central bank's view of U.S. growth for 2017 remains stable at 2.2%, while greater growth is expected in the euro area (1.9% versus its previous forecast of 1.6%), based on recent economic indicators. The pace of expansion in oil-exporting emerging market countries is projected to rise to 4.0% (up from the previous projection of 3.7%) as the impact of declining oil prices eases and emerging markets recover from recession and make progress on economic reforms.

What's next

The next scheduled date for announcing the overnight rate target is September 6, 2017.

Shenfeld notes that the bank offered no hint about the next hike, saying only that it depends on the data. But he leans toward October. "By skipping September," he says, "the bank can signal that this will be a gradual process."

Josh Nye, economist at RBC Capital markets, agrees. In an industry note, he adds that the bank didn't necessarily frame today's hike as simply reversing the rate cuts of 2015.

"Rather, we think the bank's projection that economic slack will be fully absorbed by the end of 2017 raises the risk that policy-makers do more than withdraw those 50 basis points of 'insurance cuts' over the next year," he says.

Brian DePratto, senior economist at TD Bank highlights in an industry note statements made by Governor Poloz at a press conference after the hike was announced. Poloz said the hike can't be categorized as either removing 2015 stimulus or striving to normalize interest rates.

Says DePratto: "As such, we believe that another rate hike is likely at the Bank of Canada's October monetary policy decision, but a slightly slower pace of one 25-bp hike every six months or so is likely thereafter."

At the press conference, Poloz said: “In the full course of time, I don’t doubt that interest rates will move higher, but there’s no predetermined path.”

6. Expect rate hikes and unwinding of balance sheet: Yellen

[July 12, 2017] Federal Reserve Chair Janet Yellen told Congress on Wednesday that the central bank expects to keep raising a key interest rate at a gradual pace and also plans to start trimming its massive bond holdings this year.

In her semi-annual testimony on the economy, Yellen took note of a number of encouraging factors, including strong job gains and rising household wealth that she said should fuel economic growth over the next two years.

She blamed a recent slowdown in inflation on temporary factors. But she says Fed officials are watching developments closely to make sure that annual price gains move back toward the Fed’s 2% target.

Many economists believe the Fed, which has raised rates three times since December, will hike rates one more time this year.

In her prepared testimony before the House Financial Services Committee, Yellen repeated the message she has been sending all year: the economy has improved enough that it no longer needs the extraordinary support the central bank began providing in 2008 in the wake of a severe financial crisis and the deepest recession since the 1930s.

She noted that since the depths of the recession, unemployment is now down to 4.4%, near a 16-year low. And while the economy started the year with a sluggish growth rate of just 1.4%, it has regained momentum in recent months, helped by strong job gains, a revival of business investment and a strengthening of overseas economies.

But Yellen cautioned that “considerable uncertainty always attends the economic outlook.” Those include whether inflation will indeed pick up, as well as questions about how much of President Donald Trump’s economic program will make it through Congress. She noted that while the global economy appears stronger, “a number of our trading partners continue to confront economic challenges.”

“At present, I see roughly equal odds that the U.S. economy’s performance will be somewhat stronger or somewhat less strong than we currently project,” she said.

The Trump factor

Yellen made no reference in her prepared remarks to what many investors see as one of the biggest unknowns at the moment: whether Trump will ask Yellen to remain as Fed leader when her current term ends next February. Yellen so far has deflected questions about whether she would accept a second four-term term as chair if Trump asked her to remain.

She also did not mention the potential impact of Trump's other Fed nominations on central bank interest rate decisions and its approach to its other job, regulating the nation's largest banks.

During last year's presidential campaign, Trump was critical of the central bank for its low-rate policies, which he said were helping Democrats, and for its efforts to enact tougher regulations on banks in response to the 2008 financial crisis.

On Monday, the administration announced that it had chosen Randal Quarles, a Treasury Department official under two Republican presidents, to serve as vice chairman for supervision, the Fed's top bank regulatory post.

Including the post Quarles would fill, the Fed has three vacancies on the seven-member board. All of Trump's nominations will require Senate approval.

Looking back, looking ahead

The Fed slashed its key policy rate to a record low near zero in December 2008 to combat the worst economic downturn since the 1930s — and kept it there for seven years until nudging it up modestly in December 2015. It then left the rate unchanged for another year until raising it again in December of last year, followed by increases in March and June this year. Even so, the rate remains in a still-low range between 1% and 1.25%.

At its June meeting, the Fed signalled that it expected to begin shrinking its $4.5-trillion balance sheet later this year, a step that could put gradual upward pressure on longer-term rates for such items as home mortgages.

In her testimony Wednesday, Yellen repeated the Fed's plans to increase the level of bonds that will be sold off each month at a gradual rate to give markets time to adjust. At its June meeting, the Fed announced that it planned to begin reducing its holdings by $10 billion per month.

The Fed's holdings have surged five-fold since 2008, ballooning in size as the Fed bought Treasury and mortgage bonds. By taking the bonds off the market, the Fed helped to encourage lower long-term interest rates that made it less expensive for consumers and businesses to borrow. One of the goals of gradually unwinding the balance sheet would be to not disrupt broader economic growth despite the possibility of rising long-term rates.

The Fed intends to continue to manage interest rates through its primary policy tool, the federal funds rate. But it would be prepared to resume bond purchases "if a material deterioration in the economic outlook" were to occur, she said.

7. Big banks follow BoC, raise mortgage rates

[July 12, 2017] The same day that the Bank of Canada announced its 25 basis point rate hike, RBC, TD, BMO, Scotiabank, CIBC, National Bank and Desjardins have said they will raise their prime rates accordingly.

The seven banks are upping their prime lending rates 25 basis points to 2.95% from 2.70%. All are making the move effective July 13, affecting major loans like mortgages.

The BoC on Wednesday raised its key lending rate by 0.25 percentage points, or 25 basis points, to 0.75%, marking its first interest rate hike in seven years.

Zoocasa CEO Lauren Haw says a mortgage rate increase will not impact the housing market. “The increased benchmark interest rate of 0.25% should not have an adverse effect on the housing market, as we are still in a very inexpensive lending period,” she wrote in a statement released shortly after the BoC rate decision.

“Mortgage rates remain at historical lows since the decrease seen after the 2008-2009 recession and it will take a series of increased rate hikes before we see a significant impact on homebuyers in Canada.”

She adds that Toronto Real Estate Board data from 2010, the last time rates were hiked, “show that the pattern of home sales and prices didn’t change afterward [the hike].”

Have a nice and fruitful week!

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